INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

OP:E:EO:T 3
WIL: 9999.98-00

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved:

Conference:

FACTS:

The taxpayer was incorporated under the laws of the State of Washington on August 1, 1978. Its exempt purpose is to encourage and promote the growth of amateur hockey in accordance with accepted youth movement objectives, among which are: teaching physical skills; fair play; discipline; respect for authority and competitiveness; and such other purposes within the meaning of section 501(c)(3) of the Internal Revenue Code. The taxpayer has been recognized as exempt under section 501(c)(3) since 1978.

In 1991, the taxpayer obtained a permit from the Washington State Gambling Commission to conduct bingo games and sell pull-tabs during the games. It has been conducting these activities continuously since then. From 1991 through 1996, the

30

taxpayer filed Form 990-T and paid the section 511 tax. All of the returns included gross receipts from the sale of pull-tabs, the cost of goods sold, and the deductions related to the production of the pull-tab income. Subsequently, the taxpayer filed amended returns claiming an additional deduction for the amounts transferred from its gaming account to its own charitable program and subsequently spent. These amended returns constitute timely filed claims for refund.

During the tax years under examination, the taxpayer commingled its bingo and pull-tab receipts in a gambling account, as allowed by Washington law. No other types of revenues were deposited in this account. Amounts were transferred from this account to the organization's general account. You have indicated that all amounts claimed as section 162 deductions were subsequently paid out as functional expenses from the general account. It does not appear that you have made an allocation between the bingo and pull-tab receipts for these years.

The taxpayer is operating its gaming activities under rules set forth in the 1973 Gambling Act for the State of Washington. Under this Act, only bona fide charitable or nonprofit organizations may conduct gaming. These are defined in RCW 9.46.0209 as organizations having charitable, benevolent, eleemosynary, educational, civic, patriotic, political, social, fraternal, athletic or agricultural purposes when found by the Commission to be organized and operated solely for those purposes rather than for the purpose of carrying on gambling activities. Under this section, if contributions are not deductible or the organization is not exempt from federal income taxes, the organization is not considered a bona fide charitable or nonprofit organization. The Act also creates the Washington State Gambling Commission, Chapter 230-WAC, to implement the statutory scheme.

WAC 230-12-076 sets forth licensing requirements for organizations participating in gaming activities. Organizations are assigned a regulatory group based upon the authorized gambling receipts as follows:

(1) Group 1 - gambling activities with combined annual gross receipts up to $300,000.'

(2) Group 2 - gambling activities with combined annual gross receipts up to

$1,000,000.

(3) Group 3 - gambling activities with combined annual gross receipts up to $3,000,000.

(4) Group 4 - gambling activities with combined annual gross receipts up to $5,000,000.

(5) Group 5 - gambling activities with combined annual gross receipts that exceed $5,000,000.

WAC 230-08-255 states that as a requirement of obtaining a gambling license and to maintain it, a charitable or nonprofit organization must demonstrate that it has made significant progress toward meeting its stated purposes during the period under review. "Significant progress" means that an organization has complied with requirements set forth in its by-laws and charter; has actively engaged in providing services to the public or its members during the entire period under consideration; and the services provided directly relate to the stated purposes of the organization. Such activities are deemed to be significant when an organization uses a substantial portion of its resources, including net gambling income, for providing such services. Organization in Groups 3,4, and 5, are subject to the following additional requirements:

(1) Elections to select officers must be held at least once every two years;

(2) A general membership meeting must be held at least once every two years;

(3) At least 60% of the net gambling income earned in the most recently completed fiscal year must be used in the same period as functional expenses to provide services to members or the public; [There are several exceptions to the timing of the required payout.]

(4) No more than 35% of the functional expenses may be spent for supporting service expenses. If more than 50% of the functional expenses are provided through indirect methods such as contributions, scholarships, services, then not more than 20% of functional expenses can be spent for supporting services.

Functional expenses are essentially program service expenses. [WAC 230-02-162] Supporting service expenses are administrative costs. [WAC 230-02-279]

WAC 230-12-110 provides that an organization shall not "fail to devote the entire net income of any gambling activity exclusively to the lawful purpose of the organization."

WAC 230-12-280 provides further that an organization's gambling license may be voided for failure to comply with these requirements.

ISSUES:

Based on these facts you have asked the following questions:

1. Are the requirements under the Revised Code of Washington State (RCW) and the Washington Administrative Code (WAC) that require an organization to make significant progress toward meeting its stated purpose as a condition for a gaming license so broad that they do not constitute a requirement of lawful purpose expenditures?

2. Is the distribution of net gambling income by the taxpayer in accordance with Washington law, subject to the limitations of section 512(b)(10) of the Code as a charitable contribution under section 170, or are the payments deductible under section 162 as ordinary and necessary business expenses?

3. If the payments are deductible under section 162, is the excess of the payments over sixty percent subject to the charitable limitation under section 170?

4. If a licensee is a Group I or II licensee, do the requirements of the RCW and WAC constitute a lawful purpose expenditure?

5. Is a licensee that is exempt under section 501(c)(3) or (4) entitled to a lawful purpose expenditure deduction under section 162, even though the

functional expenses required under the RCW and WAC for a charitable gaming license are not charitable payments as defined in section 170?

6. Are amounts relating to bingo proceeds (as defined at section 513(f)(2) of the Code), as distinguished from pull-tabs, that are transferred from the gambling account to the general account and ultimately expended for functional services, deductible under either section 162 or 170 of the Code.

LAW:

Section 511 of the Code imposes a tax on the unrelated business taxable income of an organization described in section 501(c)(3) of the Code, that is derived from any unrelated trade or business regularly carried on by it.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(10) of the Code permits organizations subject to the section 511 tax the deductions allowed by section 170 but not to exceed 10% of the unrelated business taxable income computed without the benefit of this paragraph.

Section 162(a) of the Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. Section 1.162-15(a) of the Income Tax Regulations, provides that no deduction is allowable for a charitable contribution or gift by a corporation if any part of that contribution is deductible under section 170.

Section 513(f) of the Code states that the term "unrelated trade or business" does not include any trade or business which consists of conducting bingo games. "Bingo game" is defined in section 513(f)(2) to mean any game of bingo where wagers are placed, the winners are determined and the distribution of prizes or other property is made in the presence of all persons placing wagers in such game.

In South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. No 11 (7/22/86), the Tax Court held that a section 501(c)(7) social club that distributes its net proceeds from the operation of beano games in accordance with Massachusetts law, was not subject to the limitations imposed by section 512(b)(10) because the proceeds were ordinary and necessary business expenses deductible under section 162 rather than charitable contributions subject to section 170. The Massachusetts gaming law required that the entire net proceeds of the beano games be used for charitable purposes and not be distributed to the members of the organization. The court decision did not rest on the purpose to which the net proceeds were dedicated. The court was persuaded that because the payments were compelled as a condition for maintaining a gaming license that the payout was not a voluntary charitable contribution, it was an ordinary and necessary business expense and deductible in full.

Similarly, in Women of the Motion Picture Industry, et al v. Commissioner, T.C. Memo 1997-518, the Tax Court held that the Texas gaming statute required that the net proceeds of both bingo and "instant bingo", a form of pull-tab, be paid out for lawful purposes within specified time limits as a condition of maintaining a gaming license. Although the statute permitted leeway as to the timing of the payout, all funds had to eventually be paid out for charitable purposes or the organization risked revocation of its gaming license. The court concluded that the payments made for lawful purposes under this statute were ordinary and necessary business expenses deductible under section 162. In this case, the amount of income and expenses attributable to the instant bingo activities was stipulated by the parties. No deductions were allowed for expenses attributable to the section 513(f) bingo.

DISCUSSION:

All of the issues raised hinge on whether the Washington State law requires that the net proceeds of the gaming activity be used for lawful purposes under the statute as a requirement for obtaining and maintaining a gaming license. To make this determination, an examination of the 1973 Gambling Act for the State of Washington, as implemented by the Washington State Gambling Commission in Chapter 230-WAC, is necessary.

WAC 230-12-110 states clearly that an organization shall not fail to devote the entire net income of any gambling activity exclusively to the lawful purpose of the

organization. An organization's gambling license is subject to revocation under WAC 230-12-280 if it fails to use any part of the net gaming income for lawful purposes.

WAC 230-12-076 and WAC 230-08-255 impose additional requirements for organizations holding gambling licenses. These focus on the organization's operational success in making "significant progress" towards the goals that are the basis for its tax exempt status. Organizations that hold Group 3, 4, or 5 gaming licenses are subject to additional requirements regarding the timing of distributions to be made and limitations on certain administrative expenses.

The Washington State statutory scheme is similar to both the Texas statute discussed in Women of the Motion Picture Industry, et al v. Commissioner, supra, and the Massachusetts statute discussed in South End Italian Independent Club, Inc. v. Commissioner , supra. It is the fact that the state law requires that funds be expended in a certain manner as a condition of maintaining a license, and the fact of possible license revocation if the funds are not expended in that manner, that renders these payments ordinary and necessary business expenses deductible under section 162 of the Code. They are not charitable contributions under section 170 as they are not "voluntary," they are mandated as a condition of continued operations. This is not changed by the fact that the State may impose further restrictions on the timing and distribution of the funds.

An organization is not entitled to a deduction under section 162 until an expenditure is made. The court in Women of the Motion Picture Industry, et al v. Commissioner, supra, noted that a transfer of funds from the gaming account to the organization's general account is not an expenditure. When the funds are spent by the organization for a lawful purpose under the statute, however, the expense is deductible under section 162. Program service expenditures are lawful purpose expenditures under the Washington State statutory scheme and deductible from the gaming receipts at the time the funds are spent.

The question of deductibility only arises in the context of unrelated business taxable income. An exempt organization is not taxed on its income from exempt activities such as bingo defined in section 513(f). This is considered support from a related activity under section 509(a)(2). Accordingly, an organization must allocate its gambling income between related and unrelated sources even when permitted by the state

to commingle the funds in one restricted gaming account. Only expenditures that are directly connected to the unrelated business income portion may be deducted under section 162. This issue was present in Women of the Motion Picture Industry, et al v. Commissioner , supra. The parties had stipulated the amount of income and expenses attributable to the instant bingo activities and no deductions were allowed for expenses attributable to the section 513(f) bingo.

CONCLUSIONS:

1. The requirements under the Revised Code of Washington State and the Washington Administrative Code that require an organization to make significant progress toward meeting its exempt purposes as a condition for a gaming license are not too broad to constitute a lawful purpose expenditure. The purposes of an organization exempt under section 501(c)(3) of the Code are, by definition, charitable. This law is requiring licensed organizations to spend the gambling proceeds for charitable purposes in addition to continuing an ongoing charitable program conducted with proceeds generated from sources that are not unrelated business taxable income. RCW 9.46.0209 specifically requires that an organization not be operated solely for the purpose of carrying on gambling activities and that it be an organization to which contributions are deductible or exempt from federal income taxes.. WAC 230-08-255 also requires an independent charitable program as a condition for holding a gambling license. Only then may the gaming proceeds be spent for additional program services.

2. Washington State law requires the distribution of net gambling income for lawful purposes as a requirement of obtaining and maintaining a gaming license. Expenses incurred to maintain the gaming license are ordinary and necessary business expenses deductible under section 162 of the Code. Thus, the limitations of section 512(b)(10) of the Code do not apply.

3. WAC 230-12-110 requires that the entire net gambling proceeds be used for lawful purposes. The additional requirement of WAC 230-08-255 that certain licensees spend 60% of the net gaming income within the current year does not change the requirement that 100% of the net gambling proceeds be used for lawful purposes though it may change the timing of the deduction. A deduction can only be taken in the year the funds are actually spent.

4. RCW 9.46.0209 and WAC 230-12-110 apply to all gambling licensees.

5. A licensee exempt under section 501(c)(3) or 501(c)(4) is entitled to a lawful purpose expenditure deduction under section 162 for expenses incurred as a condition of holding a gambling license. Lawful purposes are loosely defined in RCW 9.46.0209. The list of permissible purposes for which gaming income may be spent must be tempered by the further requirement that the organization be exempt from federal tax and use the funds in furtherance of its own stated purposes whether as an adjunct to its own program or by a program of targeted grants. A 501(c)(3) or 501(c)(4) organization incurring expenditures for non-exempt purposes jeopardizes its exempt status, whether those funds are generated by an unrelated trade or business or not.

6. Expenditures from 513(f) bingo proceeds are not deductible. An allocation must be made between the 513(f) bingo and the pull-tab income in the gaming account. If there are no records on which to base an allocation, all the funds may be considered from an unrelated trade or business. Expenditures from bingo proceeds that are not described in section 513(f) that are made as a condition of holding a gambling license are deductible under section 162 as ordinary and necessary business expenditures.

- END-